The Structure of the Northeast Dairy Industry In the Next Ten Years: What Can We Learn from the California Experiences?[1/]

In attempting to respond to this assignment, you should recognize that there are a couple of significant disadvantages going against me --

(1) I haven't been in California in the last two and a half years;

(2) From an Ohio vantage point, the Northeast milk industry is pretty tough to get a handle on, and we look east across the Ohio-Pennsylvania border with considerable bewilderment much of the time.

But I do have one thing going for me this morning--Bob Story said to use a subjective approach, and I didn't know there was any other way.

I suppose one reason we are on this topic goes back to the saying -- "If you want to know what the U.S. is going to look like in ten years, take a look at California today." Like all statements of that sort, it holds some truth, but it also holds a lot of irrelevance.

Let me cite eight more notable aspects of California's milk industry and try to relate them--up or down--to the direction of the Northeast milk industry in the next ten years.

[1/] Robert E. Jacobson, Dept. of Agricultural Economics, The Ohio State University, for presentation at the Northeastern Dairy Conference, Washington, D.C., April 3-4, 1979.

1. Politically sensitive nature of market order pricing;

2. Large size of dairy farms;

3. Use of a four class price plan with high differentials for the intermediate classes;

4. Use of component pricing;

5. Use of a closed base production program;

6. Relative weakness of dairy cooperatives;

7. Extent of vertical integration in processing-distribution; and

8. Relatively low consumer milk prices.

The general question is--How might each of these California-type factors impact the Northeast milk industry in the next decade?

Let me offer initially some industry information that can help us to find some common ground.

1. The 11.9 billion pounds of milk produced in California in 1978 were not much more than the 10.5 billion pounds produced in New York.

2. Class I usage in California in 1978 was 55 percent. This compares with 48 percent Class I in the New York-New Jersey Federal order; 58 percent in the New England market; and 55 percent in the Middle Atlantic order.

3. At the present time, there are only 2,100 Grade A producers in California. This compares with the 18,000 producers in Order 2 (NY-NJ), and nearly 33,000 producers in the three large Federal milk orders in the Northeast.

Let us now turn to the eight factors already specified:

1. Political Sensitivity of Market Order Pricing

Due to the relative absence of interstate movements of milk, California has been able to operate a State milk order effectively. The point here of mentioning the California State milk order is not to project State orders in the Northeast. In fact, there is some basis for being persuaded that the California State order would disappear and be replaced by a Federal milk order except that the California program utilizes a closed base program and it thus has some strong adherents.

The point here is simply to note the increasing political sensitivity of all milk market orders, and California was caught in that very early. Organized consumer interests have been very active in public hearings on milk marketing in California throughout the 1970's, and maybe even earlier. These interests have been significant factors in (a) forcing the State to engage in ultra-cautious Class I pricing, and (b) getting rid of regulations that authorized establishment of minimum retail prices by the State.

We now see this kind of crusade increasingly at the Federal level. Obviously, a group of perseverant and partly informed zealots have imbedded themselves in the FTC, the Anti-Trust Division of Justice, and in some Congressional staffs. The recent recommendation on market orders in the Anti-Trust Commission report was by any account a partisan, selective, and ill-informed attack.

How do these observations relate to our topic? The structure of the Northeast dairy industry in the next ten years will continue to reflect three Federal milk orders, or maybe one order, but two observations are pertinent.

a. There will be a lot more red tape and public hearing pages contending with anti-order crusaders.

b. Probably some modifications in order provisions as we know them will emerge from the criticisms.

2. Size of Dairy Farms

The structure of the milk industry at the producer level in California offers no basis for projecting what will happen in the Northeast in the next ten years. Those are two different worlds. Note the following California data:

	Number of Grade A Producers	Average Herd Size
1950	4,240 producers	70 cows
1965	3,283	179
1976	2,380	325
1979	2,100	375

The average daily delivery in the Northeast today is in the 1,500 pound to 2,000 pound range. The average delivery in California at present is close to 15,000 pounds per day. That's a scale factor in the range of 8 to 10 with respect to the size of dairy farms in California.

The factors that have led to that structure in California are somewhat unique there and do not fit much of the United States. Some of these factors include (a) the different climate, (b) the different usage of labor in production, (c) the newer milk production industry, (d) complete dedication of the majority Dutch and Portuguese milk producers to the dairy business, and (e) a so-called Southern California model that says get more cows and buy all your feed.

The factors that will affect the number and size of dairy farms in the Northeast in this next decade are the same ones that have been shaping the Northeast trends in the past couple of decades. You won't find any answers in California on this one.

3. Use of a Four Class Price Plan with High Intermediate Differentials

California has a four class price plan versus the three price classes used in the Federal order program. I think this is significant because there is a lot of logic that supports four price classes in Federal milk orders in this next decade, although on a different basis than the four classes used in California.

The California classified use price plan can be specified as follows:

a. Class IV - hard products, priced by a butter-powder formula;

b. Class III - ice cream products, priced by the B-P formula plus a 49 cent differential;

c. Class II - soft products, priced by the B-P formula plus a 62 cent differential; and

d. Class I - fluid products, currently priced by an economic index formula.

Let me advance four observations about the California classified use price plan.

a. A lot of money is generated for the pool from the high Class III and Class II differentials.

b. The money from Classes II and III takes pressure off the Class I price as a means of generating blend prices.

c. The relatively high differentials on Class II and Class III have not induced significant substitution of other solids.

d. In Federal milk orders, the different values of milk for cheese and milk for butter-powder have continued to persist in recent years, and these values have continued to be submerged into a single M-W Class III reserve price.

Given these observations, I think we can draw some preliminary conclusions. Four price classes work. In the Federal order program, there is a solid basis for moving to two reserve classes in a four class price plan. This would be different from California's plan as it has only a single reserve class, but it would respond to problems in Federal order pricing today. One effect would be to take pressure off the Class I price by using higher differentials on Class II (all soft products) and Class III (probably cheese) are compared to Class IV (primarily butter and powder). I am certain that the Northeast is going to be wrestling with this kind of a question in the next ten years.

4. Component Pricing

The question on this factor is what is the Northeast or the U.S. going to do about component pricing in the next ten years.

California has used multiple component pricing since 1962. It has worked and worked very well. And California is a large laboratory to look to as a testing ground: 800,000 dairy cows; 22 million consumers; 2,100 producers; and 130 fluid milk plants.

The real question in the U.S. today is not component pricing, but higher SNF standards. With higher standards (from 8.25 percent to 8.6 percent or more), component pricing becomes a viable option.

But I am surprised about two things in the area of minimum SNF standards for fluid milk products:

a. The complete lack of an informed and substantive rationale for the Food and Drug Administration's present minimums of 8.25 percent, as that rationale has been set forth in the Federal Register.

b. The complete capitulation of the milk industry as it has rolled over and played dead in the face of FDA, at least on this issue.

I suspect that we have by now cycled past the most recent momentum in enthusiasm for higher standards and component pricing. There is no basis today for being persuaded that we will see either higher standards or component pricing in the next ten years.

5. Closed Base Production Program

In my opinion, the California experience offers us nothing but negatives so far as closed bases are concerned. Closed bases have not controlled production (if that is a purpose), and closed bases have seriously divided producers (Northern California vs. Southern California; new producers vs. established producers; expanding producers vs. status quo producers; quota producers vs. overbase producers).

Once you have adopted a closed base program, it is virtually impossible to get rid of, and very tough to modify. This is so because of the equity values that accompany quota. Once a producer is holding that valuable paper, why should he want to relinquish it?

Obviously we are not going to see closed bases in the Northeast in the next ten years--no matter what the surplus situation might be. And California offers you some pretty good reasons why you should stay away from closed bases.

6. Relative Weakness of Dairy Cooperatives in California

It appears that so far as dairy cooperatives are concerned, the Northeast could learn a whole lot from most sections of the United States. One place where the Northeast could not learn a thing is California.

--Only about 50 percent of the producers in California are members of milk marketing cooperatives.

--There are about a dozen dairy coops in the State, but only four or so are really viable.

--The cooperatives are not closely affiliated.

--There are no such things as super-pools or Class I premiums.

--Effective cooperatives in the Midwest are viewed with reservation by many California producers.

--The effective coops in California are more concerned with serving their own membership and less concerned with finding ways of marketing milk effectively on a State-market-wide basis.

The tradition of looking to Sacramento for the solution of most milk marketing problems in California is so strong that the cooperative idea is really de-emphasized.

From the outside, the Northeast has a couple of obvious problems on the dairy cooperative front:

(a) An increasingly serious non-member problem; and

(b) A continued apparent lack of effective working relationships among cooperatives.

California basically has nothing to offer to you with respect to solving these problems. In a historical sense, they have not gotten to your stage of the problem. I would remind you, though, that the earlier use of Individual Class I contracts in California, and the more recent use of individual closed bases has, in effect, put the emphasis on individual marketing, not cooperative marketing. As a matter of principle, a system that elevates individual marketing rights ultimately pits the individuals against one another.

7. Extent of Vertical Integration

In the area of milk processing and distribution, there probably are a number of clues that California can offer the Northeast. Initially, I would note that the number of plants selling fluid milk in California dropped from 424 in 1968 to 130 in 1977, minus 69 percent in just nine years. But that is a trend we have seen just about everywhere in greater or lesser degree.

The structural dimension that has become evident in California has been the much higher proportion of fluid milk processing accounted for by vertically integrated food chains. In 1973, 29 percent of all fluid milk in California was handled by vertically integrated food chains. Today, close to 40 percent in California is handled by the Safeways and other chains. That is about twice the proportion we generally estimate for the rest of the United States. The California structure shows the following trends, and they're worth noting:

--Increasing impact of food chains in fluid processing at their "white" milk plants.

--Increasing role of cooperatives in handling reserve milk and in making soft products even while the traditional proprietary handlers stand still.

--Virtually no involvement of cooperatives in fluid milk processing.

I think these observations say something to the Northeast, and if you can talk with the people at Kroger (not in California) or Safeway (in California), you come away more convinced.

8. Relatively Low Consumer Milk Prices

The average half gallon whole milk price at food stores in California today is about 74 cents. For the U.S., the average half gallon price is approximately 90 cents. I suspect that several of the efficiencies that have led to lower consumer milk prices in California will come more and more into focus in the Northeast in the next ten years. Some of the reasons for California's lower consumer milk prices include:

a. Lower Class I prices (currently $11.40 per cwt. versus well over $13.00 per cwt. in the Northeast).

b. Efficiency in milk production.

c. Efficiency in processing-distribution.

d. Low retail prices fixed by the Bureau of Milk Stabilization until that function was dropped a couple of years ago.

e. Active consumer interests putting pressure on milk prices.

f. The dominance and competition of the vertically integrated food chains.

Several of these same factors are apt to be reflected in part in the Northeast in the next ten years. California's low consumer milk prices have been associated with very strong sales and, by some measure, a vigorous industry.

I have not talked about a number of things Bob Story identified; but these have been eight factors we can evaluate on the basis of the California experience and see what they suggest to the Northeast.